

**A Reliable Management Information System Is
Needed Before Making Funding Decisions to
Address Underreporting of Taxes on
Employer's Quarterly Tax Returns**

September 2003

Reference Number: 2003-30-175

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

September 5, 2003

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION

Gordon C. Milbourn III

FROM: Gordon C. Milbourn III
Assistant Inspector General for Audit (Small Business and
Corporate Programs)

SUBJECT: Final Audit Report - A Reliable Management Information System
Is Needed Before Making Funding Decisions to Address
Underreporting of Taxes on Employer's Quarterly Tax Returns
(Audit # 200230053)

This report represents the results of our review to determine whether the Internal Revenue Service (IRS) had implemented corrective actions agreed to in its response to our prior report entitled, *Opportunities Exist to Identify Unreported Taxes from Employer's Quarterly Tax Returns* (Reference Number 2000-30-146, dated September 2000).

In the prior audit report, we indicated that the IRS was not working the IRS-Combined Annual Wage Reporting (CAWR) Program.¹ The report discussed instances where employers potentially reported \$5.4 billion less in wages to the IRS on their Employer's Quarterly Federal Tax Returns (Form 941) than they did to the Social Security Administration (SSA) on their employees' Wage and Tax Statements (Form W-2). We recommended that the IRS increase Form 941 compliance efforts to address potential significant underreporting by employers by first reviewing the employers we identified.

In December 2000, the IRS agreed to review the employers identified in our first review. In a memorandum dated June 2002, the IRS indicated that no additional work had been done specifically as a result of our referral.

¹ The Program reviews employers who may owe additional payroll taxes on their Employer's Quarterly Federal Tax Returns (Form 941).

In summary, we found the referred cases were worked only if they were included in CAWR inventories through the IRS' own selection process. Although budget constraints and the commitment to work all SSA-CAWR² cases have limited its ability to work IRS-CAWR³ cases, the IRS has focused more compliance efforts on these cases. We were advised that, subsequent to our first report, approximately 62,000 CAWR cases resulted in assessments.⁴ Although the IRS is not working all potential IRS-CAWR cases, this is an improvement from our first review where the cases were not being worked at all.

IRS management originally informed us funding for working the IRS-CAWR Program would be cut next year. Subsequently, a decision was made not to cut program funding and, instead, keep staffing close to current levels. The decision was made despite the fact that the IRS management information system used to capture the CAWR Program's results is not working effectively.

Management information for the CAWR Program is maintained on a computer system known as the CAWR Automated Program (CAP) system. The CAP system monitors and tracks CAWR inventories and work in progress. It also generates the reports used by the Headquarters CAWR analyst to oversee and evaluate the CAWR Program.

We determined the CAP system was not working properly early in our review when CAWR Program information we requested was not available. Field personnel at IRS campuses⁵ confirmed that the CAP system was not functioning properly and could not be relied upon. CAWR personnel have been aware of the problems for some time and have requested system changes. Without reliable information, the IRS cannot make an informed decision on the placement of resources as well as the level of taxpayer compliance.

We recommended that the Director, Reporting Compliance, Small Business/Self-Employed (SB/SE) Division, work with the Modernization, Information Technology, and Security (MITS) Services organization to ensure that system changes are implemented and that the CAP system is operating as intended to provide the information necessary to properly manage, evaluate, and fund the CAWR Program.

Management's Response: The Commissioner, SB/SE Division, agreed with our recommendation and stated that multiple Requests for Information Services (RIS) were submitted in February 2003 to the MITS Services organization for improvements to the CAP and Business Master File (BMF)⁶ report systems. The requested changes have been agreed to by the SB/SE Division and MITS Services organization for

² The SSA-CAWR Program works cases where employees may not have received credit for Social Security earnings.

³ The IRS-CAWR cases are those where the employer may not have paid all payroll taxes.

⁴ An IRS Headquarters analyst provided the data. We were unable to independently verify the information.

⁵ The campuses are the data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the computing centers for analysis and posting to taxpayer accounts.

⁶ The BMF is the IRS database that consists of Federal tax-related transactions and business accounts. These include employment taxes, income taxes on businesses, and excise taxes.

implementation throughout 2004. The full suite of reports should be available within 3 months of the final implementation date, January 15, 2005.

Management's complete response to the draft report is included as Appendix IV.

Copies of this report are also being sent to the IRS managers who are affected by the report recommendation. Please contact me at (202) 622-6510 if you have questions or Parker Pearson, Director (Small Business Compliance), at (410) 962-9637.

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Background

The payment of employment taxes, including income, Social Security, and Medicare taxes, provides over \$600 billion annually to the Federal Government's budget and is a key component of the voluntary tax system. Employers that withhold employment taxes are required to file Employer's Quarterly Federal Tax Returns (Form 941) with the Internal Revenue Service (IRS). They are also required to file with the Social Security Administration (SSA) Wage and Tax Statements (Form W-2) for each employee. Forms W-2 contain the annual wage and withholding information for each employee. This is the same tax information that is summarized quarterly on the Forms 941. Ideally, all the information filed on Forms 941 should match the information filed on Forms W-2 for a given year. Finally, these employers must file a Transmittal of Wage and Tax Statements (Form W-3) with the SSA. The Form W-3 summarizes all Forms W-2.

The purpose of the IRS-Combined Annual Wage Reporting (CAWR) Program is to ensure that employers paid the proper amount of taxes, withholdings, and Advance Earned Income Tax Credits. This is done by comparing the tax, withholding and Earned Income Tax Credit information from the Forms W-3/W-2 to the tax information reported on the Forms 941.

In addition to the IRS-CAWR Program, the IRS also works the SSA-CAWR Program. The SSA refers SSA-CAWR cases to the IRS after making several attempts to obtain Forms W-3/W-2 from the employer. The majority of the SSA-CAWR cases are non-tax cases. Although most SSA-CAWR cases do not involve tax compliance, the IRS, to ensure employees receive proper credit for their earnings, works all cases referred by the SSA.

In a prior audit, we performed data analysis on employers who may have underreported their employment taxes on Forms 941 (IRS-CAWR type cases). We identified a limited sample of cases where employers potentially reported \$5.4 billion less in wages to the IRS on their Forms 941 than they did to the SSA on their employees'

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More Combined Annual Wage Reporting Cases Are Being Worked Than During the Previous Audit

Forms W-2. In our original report,¹ we recommended that the IRS work these cases and, if results warranted, expand its IRS-CAWR Program to work all such discrepancy cases. We conducted this follow-up audit to determine if the IRS had implemented corrective actions agreed to in our report.

Audit work was conducted at the Brookhaven IRS Campus² and at the Small Business/Self-Employed (SB/SE) Division Headquarters in Washington, D.C., from November 2002 to May 2003. The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

The IRS did not work the potentially underreported Form 941 cases we referred. In December 2000, the IRS agreed to review the employers identified in our first audit report. In Calendar Year (CY) 2002, we asked the IRS to provide the results of the work completed on the employers. In a memorandum dated June 2002, the IRS acknowledged that no additional work had been done specifically as a result of our referral. Our referred cases were worked only if they were included in CAWR inventories being worked through the IRS' own selection process.

Although these cases were not worked, the IRS did focus more compliance efforts on cases similar to those we provided. The IRS has advised us that approximately 62,000 cases were worked subsequent to our report. Staffing to work the IRS-CAWR Program was also temporarily increased by 33 full-time positions between Fiscal Years 2000 and 2001. Although 62,000 cases are an improvement over our first review where the cases were not

¹ *Opportunities Exist to Identify Unreported Taxes from Employer's Quarterly Tax Returns* (Reference Number 2000-30-146, dated September 2000).

² The campuses are the data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the computing centers for analysis and posting to taxpayer accounts.

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**Decisions Concerning the
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Management Information System**

being worked at all, these are still only a fraction of the potential discrepancy cases that could be worked. IRS management acknowledged that there are approximately 500,000 IRS-CAWR cases each year.

The IRS-CAWR cases are being worked on a limited basis because funds are not available to work all cases after the SSA-CAWR Program cases have been worked. We believe the cases we identified in our prior report could have given the IRS a good basis from which to evaluate whether further compliance efforts are needed to bring taxpayers into full compliance. However, the cases the IRS is now working should also provide this information.

IRS management originally informed us funding for working the IRS-CAWR Program would be cut. This funding cut would have affected how the program would be worked next year. Subsequently, a decision was made not to cut program funding and keep staffing close to current levels. The decision was made even though the IRS management information system used to capture the results of the CAWR Programs does not work effectively.

Management information for the CAWR Programs is maintained on a computer system known as the CAWR Automated Program (CAP) system. The CAP system monitors and tracks CAWR inventories and work in progress. It also generates the reports used by the Headquarters CAWR analyst to oversee and evaluate the CAWR Programs.

This management information system is not working effectively. Early in our review, we requested the number of IRS-CAWR cases worked in CYs 2001 and 2002 from Headquarters personnel. We were told that there were problems with the system and that any data may not be accurate. Eventually, Headquarters personnel had to contact each IRS campus to respond to our request. Field personnel at IRS campuses confirmed that the CAP system was not functioning properly and could not be relied upon. Some managers had to rely on other means to extract needed CAWR Programs information.

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In addition, when we requested the results of the IRS-CAWR cases reviewed, we were told that the assessments for the SSA-CAWR cases were included in the dollar figure provided. The IRS was unable to provide the results for just the IRS-CAWR cases reviewed. Without that information, the IRS cannot make an informed decision on the placement of resources, as well as the level of compliance.

The CAP system could be an invaluable administrative tool. It generates three major CAWR reports:

- The CAWR Case Status Monthly Report is a three-part report. It consists of: the Case Status Report, the CAWR & SSA Monthly Scheduled Closure Report, and the CAWR Correspondence Monthly Report. This Report monitors the IRS-CAWR and SSA-CAWR Programs by ensuring all cases are worked by the program completion date.
- The CAWR Status Recap Report provides a snapshot of the inventory, by status code or closing code, on the day the report is generated. It can be used to determine actions to be taken on the total inventory.
- The CAWR Case Type Adjustment Report generates the net adjustment and average adjustment amounts by case type.

The IRS identified the fact that CAP system reports were not accurate a number of years ago. However, due to staff involvement in the modernization of the CAWR Programs to a Windows-based environment, sufficient programming staff has not been available to work on correcting the problems. A Request for Information Services (RIS)³ was submitted to IRS' Chief Information Officer to correct the

³ A RIS is a common framework to document, control, monitor and track requirement changes to IRS computer systems and requests for Modernization, Information Technology, and Security Services support.

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problems, but the IRS does not anticipate the corrections to be implemented until July 2004.

Taxpayers expect the IRS to promote voluntary tax compliance by ensuring all taxpayers promptly pay their fair share. The IRS-CAWR Program can be an important program in helping to ensure that employers are in compliance and paying the proper amount of employment taxes. Careful and extensive analysis should be given to the results of the IRS-CAWR Program prior to making any decisions regarding funding and resource allocations. Sufficient, accurate, and reliable management information is necessary to make such an analysis.

The data captured on the CAP system can help IRS managers better manage the IRS-CAWR Program and ensure that it is operating properly. The data can also provide managers with the information needed to determine whether the IRS-CAWR Program is adequately funded or whether results could justify additional funding for the Program. Without reliable and timely program information, however, the IRS-CAWR Program may not be operating as effectively as it could.

Recommendation

1. The Director, Reporting Compliance, SB/SE Division, should work with the Modernization, Information Technology, and Security (MITS) Services organization to ensure that system changes are implemented and the CAP system is operating as intended to provide the information necessary to properly manage, evaluate, and fund the CAWR Programs.

Management's Response: The Commissioner, SB/SE Division, stated that multiple RISs were submitted in February 2003 to the MITS Services organization for improvements to the CAP and Business Master File

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(BMF)⁴ report systems. The SB/SE Division and MITS Services organization have agreed to the requested changes for implementation throughout 2004. The full suite of reports should be available within 3 months of the final implementation date, January 15, 2005.

⁴ The BMF is the IRS database that consists of Federal tax-related transactions and business accounts. These include employment taxes, income taxes on businesses, and excise taxes.

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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this follow-up audit was to determine whether the Internal Revenue Service (IRS) had implemented corrective actions agreed to in its response to our prior audit report entitled, *Opportunities Exist to Identify Unreported Taxes from Employer's Quarterly Tax Returns* (Reference Number 2000-30-146, dated September 2000).

To accomplish our objective, we:

- I. Determined which corrective actions the IRS had completed and the results of those actions.
 - A. Determined if the Combined Annual Wage Reporting (CAWR) Program Staff, working in the field offices, made an in-depth analysis of the 491 employers identified by the Treasury Inspector General for Tax Administration (TIGTA).
 - B. Determined if the Small Business/Self-Employed and Large and Mid-Size Business Divisions applied additional resources and established procedures for working this type of compliance case as a result of the original TIGTA audit findings.
 - C. Interviewed CAWR Programs Headquarters staff to obtain current Program accomplishments.
 - D. Interviewed CAWR Programs Staff, managers, and programmers to determine how the CAWR management information system is operating.
- II. Reviewed previous audit reports on Employer's Quarterly Federal Tax Returns (Form 941) and determined if any significant employment tax issues had been reported.
 - A. Reviewed previously issued TIGTA audit reports for problems with Forms 941 or Wage and Tax Statements (Form W-2).

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Appendix II

Major Contributors to This Report

Richard J. Dagliolo, Director
Kyle Andersen, Acting Director
Larry Madsen, Audit Manager
John Chiappino, Senior Auditor
Margaret Filippelli, Senior Auditor
Carol Gerkens, Senior Auditor
Arlene Feskanich, Computer Specialist

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Appendix III

Report Distribution List

Commissioner N:C
Deputy Commissioner for Operations Support N:OS
Deputy Commissioner for Services and Enforcement N:SE
Acting Deputy Commissioner, Small Business/Self-Employed Division S
Chief Information Officer CIO
Director, Communications and Liaison, Small Business/Self-Employed Division S:M:CL
Director, Portfolio Management M:R:PM
Director, Reporting Compliance, Small Business/Self-Employed Division S:C:CP:RC
Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis N:ADC:R:O
Office of Management Controls N:CFO:AR:M
Audit Liaisons:
 Commissioner, Small Business/Self-Employed Division S
 Chief, Information Technology Services M:I

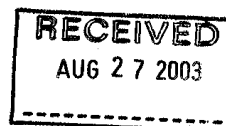
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Appendix IV

Management's Response to the Draft Report



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224



AUG 27 2003

MEMORANDUM FOR TREASURY INSPECTOR GENERAL FOR TAX
ADMINISTRATION

FROM: Dale F. Hart 
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – A Reliable Management Information
System Is Needed Before Making Funding Decisions to Address
Underreporting of Taxes on Employer's Quarterly Tax Returns
(Audit # 200230053)

I have reviewed your draft report and agree with your recommendations. This audit was initiated to determine whether the IRS had implemented corrective actions agreed to in the prior year's audit titled, "Opportunities Exist to Identify Unreported Taxes from Employer's Quarterly Tax Returns" (Reference Number 2000-30-146, dated September 2000). I appreciate your acknowledgement of the actions we have initiated to improve the quality and productivity of the Combined Annual Wage Reporting (CAWR) Automated Program.

The CAWR Program reviews Employer's Annual and/or Quarterly Federal Tax Returns (Forms 943, 941, and Schedule H for Forms 1040 and 1041) and/or Annual Return of Withholding Federal Income Tax (Form 945). This program is designed to ensure employers report and claim the proper tax and/or credits.

The integrity of our data analysis depends, in large part, on the reliability and accuracy of the management information reports. We continually strive to improve the quality and reliability of the information retrieved from the CAWR Automated Program (CAP) and the Business Master File (BMF) systems. We have submitted several requests to our Modernization and Information Technology Services (MITS) organization for modifications to the current CAWR reports. When finalized, these changes will more accurately report CAWR Program activity.

We will continue to explore ways to capture the most accurate production and assessment statistics from CAP, while initiating action to correct identified problems.

Our comments on your recommendation follow:

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RECOMMENDATION 1

The Director, Reporting Compliance, Small Business/Self-Employed Division, should work with the Modernization, Information Technology and Security Services organization to ensure that system changes are implemented and the CAP system is operating as intended to provide the information necessary to properly manage, evaluate, and fund the CAWR Programs.

CORRECTIVE ACTION

We submitted multiple Requests for Information Services (RIS) in February 2003 to the MITS organization for improvements to the CAP and BMF report systems. The requested changes have been agreed to by the SB/SE Division and MITS for implementation throughout 2004. The full suite of reports should be available within three months of the final implementation date, January 15, 2005.

IMPLEMENTATION DATE

January 15, 2005

RESPONSIBLE OFFICIAL(S)

Director, Filing Compliance, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN

The MITS Program Managers, located at New Carrollton, Maryland and Ogden, Utah will advise the Director, Filing Compliance of any delays in the schedule below.

- The following reports from the CAP system will be available on March 1, 2004:
 - *6222 Status Recap Report*
 - *Case Status Recap Report*
 - *CAWR Correspondence Report*
- The following reports from the BMF system will be available on December 31, 2004:
 - *CAWR Assessments, Abatements and Collections Report*
 - *CAWR Recon Transactions Report*

If you have any questions, please call me at (202) 622-0600 or Joseph R. Brimacombe, Deputy Director, Compliance Policy, Small Business/Self-Employed Division, at (202) 283-2200.